An HKEX Company

Discussion paper on LME warehouse reform: Feedback analysis

July 2019

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1 EXECUTIVE SUMMARY

Since 2013, the London Metal Exchange (the "LME" or the "Exchange") has led an ongoing warehouse reform process, aimed at tackling structural warehouse queues and ensuring that the warehouse network meets its core role of settlement and price convergence for LME contracts. However, the LME is also aware that LME warranting is used more broadly by metal market participants seeking to store and finance metal, many of whom believe that liquidity and transparency would be enhanced by higher stock levels.

Given the ongoing debate on these issues, and that of the overall efficiency of the LME warehouse network, in March 2019 the LME launched a Discussion Paper on Warehouse Reform (the "discussion paper"), which put forward a number of reform proposals developed by the LME Warehousing Committee with the aim of ensuring the LME physical network continues to represent best practice. The discussion paper also put forward some reform ideas as suggested by the LME, in response to feedback it had received from the market more broadly on these topics.

The discussion paper feedback period closed on 31 May 2019. This report provides the LME's summary of the feedback received in respect of the discussion paper, the LME's analysis of that feedback, and an outline of next steps where relevant.

In respect of those reform proposals with which the LME would like to progress (believing that they would add value to the operation and governance of its network, or the network as a whole), the LME has also published a consultation paper (the "LME consultation on warehouse reform" or "Consultation"), launched via Notice 19/237, "2019 LME consultation on warehouse reform". All the information pertaining to the proposals included in that consultation, and how to respond, can be found in the Consultation.

2 RESPONSE OVERVIEW

2.1 Discussion paper respondents

In total, the LME received 46 responses to the discussion paper.

The LME would like to thank these respondents for taking the time to reply and for all the comments and feedback provided. The Exchange appreciates that, in many cases, considerable time and effort has been invested by respondents in formulating their responses.

2.2 Discussion paper responses

The discussion paper was divided into three sections:

(i) Strategic proposals put forward by the LME Warehousing Committee
(ii) Operational proposals put forward by the LME Warehousing Committee
(iii) Other proposals put forward by the LME

Within this structure, the LME outlined the various reform proposals and asked a number of discussion questions ("DQ") for the market to address specifically (although for the avoidance of doubt, the LME accepted responses structured in all forms). These questions are addressed in turn in Section 3 below, along with the LME's response and proposed next steps.

2.3 Legal considerations

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3 ANALYSIS OF DISCUSSION PAPER RESPONSES

3.1 DQ1. LME stocks

Are you concerned about the level of LME stocks? To what extent should the LME take policy action to increase on warrant stock levels?

The answers adopted by respondents in question one tended to represent the principal view with which they interpreted the role of LME warehousing and what should be the LME’s primary drivers when managing this network. Consequently, the attitude to stock levels represented in these responses served to shape respondents’ answers to later questions, particularly on LILO, QBRC and headline rents.

As stated within the discussion paper, the LME did not, at the time of writing, have a view on maintaining or increasing the level of on warrant stocks as a policy aim. However, many respondents seemingly disagreed with this perspective when answering this question and broadly respondents can be placed into three categories; (i) those that were concerned with low stock levels and believed the LME should take policy action to increase on warrant stock, (ii) those that were concerned yet did not recommend LME policy action as they doubted its utility, and (iii) those that were unconcerned and did not think the LME stock should be the LME’s concern.

Respondents that were concerned about low on warrant stock levels cited numerous reasons as to why this was detrimental to the LME and its market. To attempt to substantiate that recent LME stock levels were low, one respondent referred to the statistic that total LME stocks have fallen from more than 7 million tonnes in 2013 to 1.7 million tonnes at the end of March 2019. Also, it was maintained in a number of responses that stock liquidity was crucial to the exchange. This is because a fundamental component of the LME is the effectiveness of the LME price to the metals industry. Respondents argued that rising levels of world metal stocks sitting off warrant, and therefore not making up the LME price, meant that the utility of the LME price to the metals industry could deteriorate. Increased transparency was a common theme amongst this group and LME Aluminium was cited as an example; with stocks (excluding China) only accounting for 15% of the global total. Additionally, many of these respondents raised market abuse concerns that arose from low liquidity. It was argued that a low stock environment offers larger market participants a greater opportunity to control physical stock, control shipping capacity, and impact futures positions and market premiums. Additionally, one respondent argued that chronic low stocks can cause frequent technical backwardations which can become endemic and increase the risk of a disorderly market. They asserted that higher liquidity is preferable as it keeps markets functioning efficiently and adds transparency. From a warehousing perspective, one respondent argued that low stock levels could disincentivise warehouse companies from entering and maintaining their locations within the LME warehouse network.

After establishing their belief that low stocks were detrimental, a number of respondents indicated that LME policy actions could help improve liquidity. The main focus of these recommended policy changes was around warehouse operations. It was reasoned by this group that the LME should take action to ensure that warehouse operators can function in a manner which attracts inventories from off warrant to on warrant, and that a major cause of low on warrant stock levels was that storing metal in the LME network is unattractive due to high warehousing charges and inefficiencies of loading out. Furthermore, it was stated by a smaller group of respondents that any policy change from the LME should be to simplify the complicated ruleset which currently governs the LME warehouse network. This would subsequently increase the network's attractiveness to market users. These respondents also cited their answers to discussion questions on headline rents, QBRC and LILO as further guidance on what policy amendments could be made.

Conversely, despite concern for LME stock levels, another group of respondents advised against further LME policy action, arguing that amendments were only likely to add complexity and drive more material away from the Exchange. They asserted that over-regulation and complications in dealing with the Exchange had already resulted in the lower stock levels.

Those respondents who reported themselves as unconcerned with current LME stocks, broadly took the view that stock levels should not be viewed as anything more than a constituent part of the physical market picture, and consequently, that low stocks could simply be, amongst other things, the result of the good global economy in the last few years. They contended that in the LME market, if stocks are too low, there will be a backwardation that will encourage metal onto warrant thus maintaining suitable stock liquidity. Answers from this group questioned the appropriateness of an LME policy encouraging higher stocks and asserted that the purpose of the LME's warehousing network has always been to provide a market of last resort for metal owners who need to deliver against a position, and for consumers who cannot source metal from physical markets. One respondent cited that the global recession in 2008 acted as a clear example of this; when physical demand dropped off, metal was placed on warrant as a last resort. By further policy action encouraging warehousing incentives, it was argued, the LME would change its role to a market of "first resort", a role which these respondents did not believe the LME should undertake. They warned that forcing material on warrant may instead result in metal leaving the LME warehousing system entirely.

3.2 DQ2. LME analysis of stock levels

Do you agree with the analysis set out in Section 2.3? If not, why not?

The LME, in Section 2.3 of the discussion paper, presented its analysis of the drivers of metal onto LME warrant. While most respondents agreed that the market fundamentals analysis was correct, they also pointed out that the high free on truck and rent rates meant that except for the crucial role of delivering against positions, users were discouraged from using the LME as "last resort". It was asserted that the LME should not aspire to be a physical clearing market where metal flows into the LME en-route from producer to consumer, as this would dilute the fundamental purpose of the Exchange in being a physical market of last resort.

A far higher number of responses focused on the logistics and incentives analysis. For the logistics analysis, again most agreed with the LME. However, some respondents argued that the discussion paper's description as to why LME warrants are the "gold standard" was incorrect. They argued it was not the security of the compound or the logistical efficiency of the LME warehouse network that attracted users, but the legal certainty of ownership and fungibility that an LME warrant provided that was the main attraction for stock. Additionally, respondents mostly agreed with the analysis that the lack of transparency offered by off warrant stocks and its low price comparative to LME storage was a key to metal remaining off warrant. However, they also pointed out that the LME network logistically may not have the preferred warehouse location for some metal owners, or that some market participants were put off by the strict LME policies and these factors also kept metal from entering the LME system.

The paper's analysis of incentives also featured heavily in numerous answers, particularly in response to the LME's assertion that it understands incentives represent a key element of the reality of metals warehousing. One respondent argued to the contrary, and stressed that incentives were not necessarily a key element of LME warehousing but instead served to be disruptive to the market. Another added that low or zero incentives do not necessarily mean that metal will not flow onto LME warrant. They asserted that when producers and traders are unable to find buyers for metal, the LME remains the market of last resort and this would naturally occur without warehouses offering incentives. Consequently, this respondent believed that competition between warehouses should be based upon cost and quality of service rather than the quirks of the LME system.

The paper also stressed that certain warehouse operators believed that LME reform may have progressed too far, that in some circumstances the QBRC Rule may result in the warehouse having to provide free storage and in this circumstance, the willingness of the warehouse operator to pay incentives may be reduced. In response to this analysis, many respondents referenced their answers to question three (relating to QBRC) but reiterated that they did not believe that the 2013 LME reform "may have progressed too far." One respondent also argued that this analysis of warehousing beliefs was incomplete and failed to address the core considerations of what is influencing warehouse company behaviour. In particular, they noted, the analysis focuses on QBRC, which they argued was not a material factor in how a warehouse operator assesses how aggressively they pursue opportunities to warrant material. More generally, one respondent contended that they agreed with the analysis but it should also be noted that it was relevant only to metal that met LME storage and shape conditions, and consequently, was not applicable to the vast tonnage of metal that did not meet these requirements.

3.3 DQ3. QBRC Rule

Do you agree with the proposal to change the parameters of the QBRC Rule? If so, do you believe that 80 days represents an appropriate parameter?

Some advocates of the proposal suggested that extending the parameters would allow warehouse operators to organise themselves commercially to attract more metal from off warrant to on warrant storage. One respondent argued that the proposed increase would keep the minimum guaranteed rent which a warehouse earns capped below the historical average premiums for the region and felt that the reform would not cause any abnormal distortion to physical market premiums. Several respondents further felt that the proposed parameter of 80 days was an appropriate measure; a welcomed departure from the tiered rent charging model to a simpler 80 day full rent charge model. However, one respondent in the group supporting the parameter change argued that the current 2 step system of capping rents by half and then eliminating rent at a certain threshold was a compromise that matched the interests of both metal holders and warehouse operators. They therefore suggested the LME increases the threshold for the 50% rent cap to 60 calendar days, and the threshold for no rent at 90 days.

Market participants that opposed the proposal broadly echoed the view that extending QBRC to 80 days would create a heightened risk of queues forming. One respondent emphasised that the extension may simply lead to a maximisation of queues for a longer period and highlighted that parts of the community have demonstrated an ongoing willingness to maximise storage strategies around the LME Rulebook. A concerned participant further argued that such extension would immediately lead to an increase in the maximum incentive payable by warehouses, which they felt would not be a desired change as it would reduce warehouse competition. This view was reflected by other respondents who noted that extension would be a step in the wrong direction, thus translating into artificial incentives. Negative impact on the LME cash price and increased physical market premiums were also mentioned as potential undesirable results of the extension.

The LME notes the assertion of warehouse operators that the creation of structural queues – evident following the global financial crisis of 2007-2008 – is no longer a core element of their business model. However, this clearly needs to be proven in practice. As such, the LME considers that the advancement of extension of QBRC to 80 calendar days, with no 50% rent period, may be an appropriate measure. At the same time, the LME does accept that the potential negative impact on the market is a reasonable concern and, as such, is proposing to implement the parameter change on a phased basis, so that the effects of such implementation can be observed by the Exchange and by the market. Full details on the proposal and the rationale are set out in the Consultation.

3.4 DQ4. Evergreen rent deals

Do you agree with the proposal to require the termination of evergreen incentives prior to physical load-out of metal? If so, what do you believe is the appropriate mechanism by which a new metal owner can terminate pre-existing rent share agreements?

Those that supported termination prior to physical load-out argued that an appropriate mechanism to terminate pre-existing rent share agreements could apply upon cancellation of the warrant or on request from a metal owner. One respondent supported the idea of termination at cancellation and recommended that the LME considers applying such rule to new evergreen incentives only, therefore suggesting that such a rule would not impact those agreements prior to a certain implementation date. This group also considered issues of confidentiality, noting that termination before load-out would reduce the risk of breach of confidentiality, as the link between warehouse operators and previous owners would no longer exist. One respondent argued that no commercial purpose existed for market participants to share rent beyond warrant cancellation (as counterparties would no longer bring further value to the transaction) and, consequently, the sharing of rent could have a disorderly effect on the market.

At the opposing end of the spectrum, several respondents believed that these deals are important to the market in incentivising metal to be stored on warrant, which benefits the market as a whole. To this effect, one respondent argued that rent-share deals are an important part of the instruments warehouse operators use to attract metal. A further respondent took the view that participants who bring metal into the warehouse system should benefit from evergreen rent deals.

Others also disagreed with the proposal. However, they considered the impact from a different lens, arguing that the proposal would result in higher incentives required to attract cargo. Moreover, some respondents took the view that such deals should be prohibited or banned entirely. One respondent who took this view noted that evergreen incentives should not be allowed; however, cash incentives should instead be provided on delivery of material. However, such views were relatively uncommon.

Finally, some respondents felt that the LME should interfere as little as possible in commercial arrangements. One supporter of this view argued that the market would probably find new loopholes and incentives either way, therefore suggesting that the proposal would not be beneficial.

Feedback received reiterates that the debate over the use of such deals is still ongoing and the market is broadly split on the benefits. The LME understands these varying viewpoints – and, as a general matter, believes that commercial arrangements between participants are for those parties to negotiate, and the LME should only place restrictions on such arrangements in limited circumstances (i.e. where such are distortive, manipulative or have a negative effect on the market). Further, the LME believes that incentives continue to play an important role in attracting metal on warrant, especially in light of the difficulty of achieving this through logistical optimisation – as is fully explored in the Consultation. As such, the LME is proposing a hybrid approach that continues to allow evergreen rent deals, but only on new metal (i.e. metal not already on warrant). This, and the associated caveats, are fully set out in the Consultation.

3.5 DQ5. Headline rents

Do you agree that headline rents should be lowered? If so, and if you are a user of off warrant storage, would you expect to make greater use of the LME warehousing network?

Responses to this question tended to fall into three main categories:

(i) The first group took the view that high headline rent rates discourage physical market actors from making greater use of the LME warehousing network, particularly when considering the comparatively cheaper rent rates offered in the off warrant space (a space they argued that offered almost identical storage benefits).

Many respondents took the view that LME stocks had been decreasing because of the cost differential between on and off warrant warehousing. It was argued by this group that the cost premium that LME storage required no longer had any rational link to the actual cost of storage. (This view was, challenged by another respondent who believed that the additional risk management, security and simplification of trade complexity that LME storage offered justified the additional premium). Most respondents who believed in lowering headline rents still believed that LME storage merited some premium. However, their assertion was that if rent levels were more aligned with the off warrant storage market, more material would come onto LME warrant because of the preference for LME warrants at financing banks and insurance companies. Furthermore, these users stated that current high headline rents subsidised low off warrant rents and, consequently, if headline rents were to be lowered then off warrant rents would in turn become higher, tightening the spread between the two and attracting more metal into the LME warehousing network.

Proponents of lower headline rents argued that the artificially high rents were causing market inefficiencies which acted as barriers to entry for potential commercial users (as opposed to financial users who used the LME, due to incentives paid, as a market of 'first resort') of the LME warehousing network who wished to use the LME as a market of last resort for sourcing and selling of their metal. They argued that the incentives warehouse companies were paying to users to place metal onto LME warrant, so that they could collect the high headline rents and were encouraging inefficient practices. One practice they highlighted was the queue business model, whereby warehouse companies are incentivised to delay and frustrate the load-out of metal so that a queue is formed where full rent can be charged. They argued that these subsequent queues, caused originally by the high headline rents, result in reduced availability of metal and disrupted trade flows

(ii) The second group took the contrary interpretation that high headline rents, and the consequent incentives offered by warehouse companies to place metal on warrant that they enable, were crucial in driving metal onto LME warrant.

These respondents opposed the view that headline rents should be lowered, asserting that any reduction in rent could never be sufficiently large to bring headline rents as low as off warrant costs. They asserted that commercial users would not start using the LME warehouse network more frequently with a small reduction. One respondent pointed out that reducing headline rents (and thus warehouse revenue) with all other variables remaining static, would reduce the magnitude of the incentives offered and therefore under most market conditions, reduce the amount of stock brought into the LME system. Proponents of this view argued that incentives caused by high rents were crucial in bringing in stock to the LME system. Moreover, these incentives were critical in the established business models of many traditional LME users who relied upon them and, they argued, these are the most important users in supplying the LME warehousing network. Respondents also noted that the income received by the warehouse companies from headline rents was fundamental and lowering headline rents would deteriorate the profitability of LME warehousing, putting the whole LME warehousing system at risk. They added this income was particularly important at a time when lack of space and soaring costs at major ports is already putting LME warehousing business models under threat

(iii) The third group took the view that the vast majority of metal held in the LME system is not held under headline rent rates and instead, accordingly, any lowering of these rates would be unlikely to influence usage of the LME warehousing network.

These respondents indicated that headline rents had little influence on the actions of those that hold the majority of metal in the LME warehousing network. This is because, they asserted, the market understands that rent levels are simply the maximum level that can be charged and the majority of metal is held with the warehouses on bilaterally negotiated rents (which are considerably lower). As a result, the lowering of headline rent would have very little impact on the behaviour of the bulk of users that place metal on-warrant. On the other hand, one trader pointed out that these negotiated rent deals are unfair on small and medium sized traders which are still subject to the headline rents and are therefore disincentivised from ever placing metal on-warrant. A respondent also commented that previous attempts to reduce headline rent rates to attract additional stock on-warrant had yielded very little response from the market

Finally, and separately from the question, an assertion was raised around the appropriateness of the LME centrally determining the headline rent rate. On this topic, one respondent suggested there may be a conflict of interest for the LME on the subject of headline rents due to the percentage income the LME receives from headline rents being applied. If the LME were to make this contribution a fixed charge on the warehouse rather than being tied to stock levels this would be, in the respondent's view, more suitable.

The LME believes that respondents have raised valid concerns and understands that headline rent rates have the potential to influence a wide variety of users. The LME respects the view of those respondents who believe that a significant reduction in headline charges could encourage more metal to flow onto warrant. However, as shown by the variety of responses received, any substantial lowering of headline rent is likely to have many unforeseen consequences for several market participants; it is the LME's view that such risks are not yet merited. Furthermore, it is not clear to the LME that, even with a material reduction in headline LME warehouse charges, that it would be ever be feasible for the LME warehousing network to compete with off warrant storage, purely on the basis of cost (even before issues of stock transparency are considered). The LME therefore proposes to freeze headline rents for a further five years which would, at a minimum, prevent the delta between headline rates and "real" storage rates widening, albeit accepting that it would not be likely to materially reduce that delta. This proposal is considered in more detail in the Consultation.

3.6 DQ6. Free on Truck ("FoT") rates

Do you agree that FoT rates should be subject to reduction, or should they be considered out of scope?

Arguments for and against an FoT rate reduction and whether or not its inclusion should be in the scope of the LME's warehouse reform were comparable to the viewpoints expressed in question five. Respondents could broadly be placed into two categories: those who believed that rates should be reduced and those who believed rates should not be considered within the LME scope of warehouse reform (and in some cases, in the LME's remit at all).

For those that held that rates should be reduced, a key component of their argument centred on the contention that LME FoT rates are significantly higher than "commercial" FoT rates. This group of respondents argued that warehouse operators frequently charge the maximum (or close to the maximum) rate allowed, which more often than not does not reflect the true cost of the warehousing services being provided. Many in this group contended that it is fairer for the warehouse company to charge a more accurate rate for the service they perform, so they are not incentivised to deliberately create inefficiency in loading metal out. Additionally, this is also fairer, they assert, to the consumer who then is not required to pay what they see as a "tax" for attracting metal into LME storage.

In respect of the view that FoT rates should not be in scope due to the impact this would have on the related forward agreements based on this FoT rate, this group of respondents argued there could be operational and contractual constructs that could solve this issue. One of the approaches suggested was that an FoT reduction could be phased in over a number of years to avoid disruption to long term contracts with embedded FoT assumptions. Similarly, another respondent argued that FoT charges could be reduced as of the date that the new rule comes in to effect, with metal warranted prior to that date being chargeable at the old rate and subsequent metal added under the new lower rate.

A much larger group of respondents were against any LME FoT rate change – or considered it inappropriate for the LME to include FoT rates in scope – and they provided a variety of rationales for this. An answer given by many respondents was that the high LME FoT rate functions as a proxy for the LME warranting incentives paid by warehouses to metal owners. Reducing the FoT would only reduce incentive levels paid by warehouses and reduce the metal inflow into the LME warehouse network. These respondents also argued that any reduction in FoT would negatively affect these established business models and would serve to negatively impact conventional users of the LME. Additionally, one respondent challenged the assumption that the high FoT rates were not reflective of the warehousing service provided. They emphasised the structural costs in running an LME warehouse (risk management, security, complexity of multiple parties involved in a trade) and asserted that these justified the high rates.

As with rents, in light of the arguments above and the LME's own analysis, the LME is proposing to freeze FoT rates for a further five years. For further information on the LME's FoT proposal, please refer to the Consultation.

3.7 DQ7. Electronic Certificates of Analysis ("CoAs")

Do you support the mandating of electronic CoAs ("ECoAs")? If so, over what time period do you believe that such a change could feasibly be required?

Several respondents, from all market segments, championed ECoAs and declared the current paper system as archaic and inefficient. The LME found numerous respondents upheld the viewpoint that ECoAs would improve the efficiency and traceability of material. One respondent argued that the current system potentially discourages efficient movement of material within the LME and thus supported the move. Another noted that mandating ECoAs would improve the ability to warrant material, as in their opinion, the current model leads to significant delays due to waiting time duration for CoAs being provided where warrants are cancelled.

Considering the applicability and implementation, one warehouse promoted the idea and noted that most CoAs they receive are already electronic (in PDF). However, this respondent also expressed concerns around formatting and standardisation, calling out that when ECoAs are received from market participants other than the primary source (the producer), many do not have the original text data thus restricting accurate searches. The quality of the ECoA is generally degraded due to the original CoA being printed, scanned or faxed, one or many times before. Instead, they recommended that a single, LME-hosted ECoA database for all LME material is implemented, which would help to avoid such issues. Several respondents mentioned the ECoA form and that standardisation is needed, with some suggesting that the LME work with producers in order to agree a format and corresponding timeframes.

On the other hand, two respondents disagreed with the mandating of ECoAs. The first highlighted that doing so would lead to a large burden for producers of LME registered brands, as it may be technically impossible for homogeneous documents to be produced without a large amount of investment. Moreover, the participant noted that mandating ECoAs could create a "two tier market" where participants may favour taking delivery of new ECoA warrants compared to those with paper CoAs. The other respondent felt that modernisation should be market-led and not mandated by regulation.

Finally, in respect of the time period for implementation, the market responses received were diverse, with some suggesting three years and others suggesting as short as 6 months. As mentioned above, others reiterated a desire for the LME to work with producers to agree such timeframes.

The LME recognises and agrees with the broad industry support that the introduction of some form of ECoA would be of significant benefit. However, it also notes that there remains some considerable discrepancy over what form those ECoAs should take, or much functionality it should provide and as such, does not believe that it has the mandate to move forward at time. As a result, this is not included in the Consultation. However, the LME does believe that it now has a role to play in working with the market to assess demand more accurately, agree a scope for such a service and map out a route forward that is feasible across a broad spectrum of participants. The LME is committed to achieving this end and further updates will be provided in due course.

3.8 DQ8. Load-out definition

Do you support allowing warehouses to discharge metal not in accordance with the definition of load-out, provided that minimum quantities of qualifying "load-out" have been achieved? In any event do you believe that the definition of load-out should clarified to reflect a definite position on this issue?

The cluster of respondents supporting clarification to the definition of load-out noted that further explanation would help make clear the current LME position and reduce the present perceived ambiguity. A number of these respondents further expressed the view that the LME should take steps to ensure conformity with the LME Policy on the Approval and Operation of Warehouses (i.e. the clarified definition of load-out). Considering the question from a different perspective, one respondent suggested that clarification should be based on "scheduled load-out". This is where metal scheduled for delivery to consumers has queueing priority over warrants which have simply been cancelled, in practice providing priority to warrants which are both cancelled and scheduled.

Taking the contrary position, a small group of respondents supported the proposition to allow discharge of metal to any destination (i.e. not per the LME requirements for load-out) on the basis that minimum quantities of qualifying load-out had already been achieved. An opinion also shared by these respondents was the view that warehouses should be able to choose to load-out additional cargo for clients should they wish. However, it was argued that changing the rules would make discovering the length of LME queues less transparent and could create market distortion that would render the warehousing system more inefficient, due to warehouses having the ability to decide the rate of discharge regardless of the load-out rules.

Other respondents indicated that the definition of load-out did not require clarity as the existing definition was sufficient for their own understanding. However, these respondents did express the view that if there are various interpretations or definitional discrepancies by other participants then there is merit in clarification by the LME.

To date, the LME has maintained that the current definition of load-out requires that all warranted metal should be loaded-out in accordance with its requirements and should not be interpreted as allowing market participants to freely discharge on warrant metal in accordance with its preferences and those of the metal owners. However, the LME is amenable to a clarification of this point in the drafting of the rules, to avoid any scope for doubt. This clarification should reflect the position that warehouses should not discharge metal in a way that is not in accordance with the load-out requirements. The LME will proceed on this basis and propose clarification to ensure consistent interpretation and mitigation of market ambiguities in the Consultation.

3.9 DQ9 & DQ10. FoT currency denomination and LME clarification

Do you support the denomination of FoT charges in USD? And as an alternative, do you support clarification by the LME that FoT charges can be paid in USD by agreement of the warehouse operator and the metal owner?

Those supporting denomination in USD generally stated that book-keeping would be more straightforward as a result of standardisation. One respondent argued that the current model is inconsistent due to the fact that rents are charged in USD whereas FoT is charged in local currency. Another respondent supported the move as standardisation in USD would allow them to hedge currency and thus no longer run the risk of exchange fluctuations. Some respondents, despite supporting the denomination change for convenience reasons, pointed out that it may not be practical or advisable when considering the interests of local operations, which have their cost base denominated in local currencies.

Many market participants, on the other hand, did not agree with denomination of FoT charges in USD. One respondent noted that the possibility of charging FoT rates in local currency protected warehouse companies from currency fluctuations. Other respondents felt that FoT rates should reflect the cost of the local service performed and thus favoured the status quo. Several proponents additionally emphasised that FoT should be payable in either USD or local currency by mutual agreement. As such one advocate believed that both parties should be able to agree the currency and conversion rate, whereas another respondent took a similar stance but suggested that warehouses should be obliged to accept both USD and local currency. This respondent therefore proposed that respective exchange rates should be dictated by the exchange rate at 1300 GMT on cancellation.

Several respondents on both sides supported clarification by the LME that FoT charges can be paid in USD by agreement of the warehouse operator and the metal owner. Many participants viewed this position as a middle ground and several acknowledged this as a practical approach. At the same time, many respondents with a neutral stance on the question noted their stance as “indifferent” with regards to whether the LME should provide clarification. However, one respondent raised a concern in respect of the exchange rate used by some warehouses, noting the huge variance between these and the market rate. They argued that some warehouses use the FX as a profit centre, with others calling for the LME to publish the exchange rates on a daily basis in order to avoid this situation.

The LME agrees with the broad market consensus that a practical route forward would be for the LME to clarify that FoT rates are allowed to be paid in local currency or in any other currency that the parties agree (including USD), provided that both the warehouse company and metal owner agree a conversion rate. This is included in the Consultation as a result.

3.10 DQ11. Eligible stock reporting

Do you support the principle of eligible stock reporting? If so, do you believe that it can be properly reflected in a rule which precludes avoidance, and meaningful data thus generated?

Increased market transparency was identified as the key theme underpinning the answers of those who supported the proposal, whereas respondents who objected mainly focused on the argument that confidentiality of stock is an integral principle for many market participants.

Several respondents that associated market transparency with the principle of eligible stock reporting recognised the myriad ways through which it may be possible to circumvent similar reporting rules on other exchanges. These respondents supported the idea of a new reporting rule, commenting that it would add a further barrier for those participants bypassing transparency guidelines or involved in “opaque stock building.” One respondent also argued that, on balance, they would support greater transparency and suggested that warehouses should report a separate “prepared for warranting” category on a periodic basis. Another respondent went further, suggesting that the LME should publish data on the build-up of all associated metal (cancelled but not yet scheduled metal, cancelled and scheduled metal, metal held on warrant, and metal that was eligible to be delivered on warrant), thereby allowing market participants to combine and analyse for themselves. Regarding the question of whether meaningful data would be generated, several respondents agreed with the notion, commenting that such information would be extremely useful in understanding the metals market.

On the other hand, several respondents argued against eligible stock reporting, noting that such information should remain confidential (should the metal owner wish) and that further reporting could jeopardise the warehousing and logistics business. They argued that the reason many users store their metal off warrant is to ensure it is not included in reports. Additionally, several respondents argued that LME stock would further be impacted, as metal owners would be disincentivised to hold stock on warrant. Furthermore, some respondents argued that this requirement would be very challenging operationally from a warehousing perspective and would only increase the burden for warehouse operators as a result of a reform package that was supposed to simplify the LME warehousing rules and not add complexity.

The LME recognises the complexity of this issue and agrees that finding a reporting structure that results in meaningful and reliable data represents a considerable challenge, especially in light of the preferences of the portion of the market who do not wish to provide greater transparency. However, the LME does not believe that these challenges represent a sufficiently compelling reason not to try to provide the market with such transparency, given the benefits this could bring – not least for the purposes of market orderliness. As such, the LME is putting forward a model for off warrant stock reporting for its physical market network for consideration as part of the Consultation.

3.11 DQ12. Scheduling load-out

Do you agree that the ability to cancel warrants, but not then schedule load-out from the warehouse, is an important feature for the market?

Responses received were grouped into two main classes: (i) respondents (the majority) that viewed the model as an important feature of the market and (ii) respondents that held the contrary view and broadly believed this feature led to market misrepresentation.

Market participants supporting the principle believed it to be an important feature of the market and asserted that this type of activity often took place. These respondents broadly took the view that the optionality to hold metal as ready for delivery but not scheduled is key for the operation of many market participants as it allowed traders important flexibility. Several respondents expressed that a load-out delay is useful where a warrant has been cancelled in anticipation of future sales (for example, where sales are pending confirmation). Obtaining and “locking-in” preferential rent rates were also highlighted as legitimate reasons for engaging in such activity. Another respondent argued that the prerogative to load out should remain with the metal owners so they can schedule a shipment when they choose, and it is not for warehouses, nor the LME, to dictate scheduling.

In contrast, those that argued against the cancel and not schedule ability believed this behaviour could incentivise market users to manipulate the market or to engage in other types of misconduct as such activity could be used to distort the warehousing system. These respondents noted that cancellations, along with queues, are reported and from this data market participants are able to ascertain the quantity of metal scheduled for shipment and make decisions on that basis. If this metal in fact does not get used for shipment and stays in the “cancelled” status then the data reported is undermined. One respondent proposed an alternative rule where metal owners should be required to schedule load out within 15 business days of warrant cancellation.

The LME accepts the argument that being able to have metal cancelled but not scheduled for load-out remains an important feature of its market, providing flexibility, amongst other benefits, for market participants. Although it remains concerned about the potential for abuse, as outlined in the discussion paper, the LME does not believe that these concerns are sufficient to take further action at this time. As such, the LME proposes to leave this functionality as it currently operates.

3.12 DQ13. Stock reporting

Would you support a change to the stocks report as set out in this proposal (either aggregation, or three separate categories), or do you prefer to maintain the current report format?

The majority of respondents supported a change to stock reporting into three categories, namely (i) live, (ii) cancelled but not scheduled-out, and (iii) scheduled-out.

Those who supported the changes to stock reporting to include the three separate categories advocated that reforms would help develop market transparency. One respondent noted that three categories would allow participants to better understand the actual status of the current cancelled statistics and what the likely intention was for the metal. Another member noted that transparency would make clearer when warehouse queues would likely form and would help warehouse operators be held accountable when such queues emerge. Other respondents also generally supported expanding reporting to three separate categories. However, they suggested that "cancelled but not scheduled" should be additionally split into: (i) cancelled but not scheduled, less than 1 week since cancellation, and (ii) cancelled but not scheduled, greater than 1 week since cancellation. The LME also received the view that aggregation would not be possible as the LME Lending Rules are based on the number of live warrants and thus, it is important that this category is kept segregated in daily reporting. One respondent supported the proposal as they believed the approach would maintain the integrity of the current report whilst providing additional and valuable information on physical demand.

Other respondents disagreed with stock reporting changes, with one arguing that the current level of detail in reporting is adequate, and that further granularity in practice would not contribute meaningful data. Another respondent argued that changing reporting would not resolve the transparency issues highlighted in the discussion paper, and instead suggested that these issues are a result of trading strategies rather than inadequate reporting.

The LME agrees with those respondents that supported further granularity on the basis of the benefits that it could provide in respect of transparency. There are some implementation issues regarding this proposal, and the LME's full analysis of such, as well as proposed next steps, is included in the Consultation.

3.13 DQ14. Copper batch references

Do you support the rule on marking producer batch references on copper? If so, do you support the delay of the implementation of this rule? Do you have any alternative suggestions for addressing this issue?

Respondents supporting the proposal agreed that marking the batch reference on the top cathode of each copper bundle would be a positive step towards traceability. Several respondents within the group also supported delaying implementation due to the potential risk that copper produced prior to implementation, without the reference, may become ineligible for warranting. One respondent, although supporting marking, suggested that such a rule should only be introduced for new copper production to ensure other deliverable copper can still be warranted on the LME. The LME noted suggestions to delay implementation ranging from three to five years, with one supportive respondent requesting that further industry discussions take place in order to agree how best to implement the proposal.

Respondents who disagreed with the idea of introducing copper batch numbers echoed the view that implementation could lead to an inability to re-warrant older, unmarked material and thus this could be disruptive to the market. Several producers argued that implementation would result in additional production costs which would not be proportionate considering that a large quantity of copper is delivered direct to consumer and not to exchange warehouses. One producer noted that the addition of batch numbers would not necessarily improve traceability as information is already included on labels with all necessary tracking information. A further respondent suggested that warehouse companies should instead maintain better traceability of material with due handling care and keep custody of original shipping documents.

The LME does believe that in the longer term, the producer batch reference should be marked on copper directly, rather than on a label. The LME acknowledges the feedback of respondents and concerns raised by both supporters and proponents to potential impact of inability to re-warrant older metal and the disruption this could cause. This topic does not form part of the Consultation and the LME will communicate this feedback back to the LME Copper Committee, where this idea arose, for further development.

3.14 DQ15. Additional comments

Are there any other matters which you wish the LME to consider in the context of this Discussion Paper?

There were a number of further ideas and comments put forward for consideration by the LME by a variety of respondents in regards to any further potential warehouse reform. These comments varied greatly. Common themes included: the expansion of the LME warehouse network to further jurisdictions (with Mainland China the most common jurisdiction suggested), the simplification of LME warehousing rules and processes, and the implementation of a daily tonnage rate that increased with warehouse capacity.

The LME was encouraged by a number of respondents to consider exploring possibilities of developing a warehousing network in Mainland China. These respondents argued that a warehouse location in that jurisdiction would increase the transparency for a large quantity of metal inventory that is crucial to the world metals market, yet not easily deliverable into the LME warehousing network. A Mainland Chinese location, it was argued, would also improve the convenience of spot circulation, thus reducing the manipulation of inventory.

Many respondents also strongly advocated greater simplification in many areas linked to LME warehousing. Simplification of rules and warehousing operations, it was asserted by respondents, would promote competition and efficiency. Additionally, it was argued that simplification and clarity of fee structures and policies may result in more streamlined processes, reduced delays and ultimately less disputes and conflicts amongst stakeholders.

Furthermore, some respondents answered that they believe it would be beneficial for the LME to consider implementing minimum daily delivery tonnage requirements which would be in proportion to the tonnage stored at that warehouse. As further explanation, one respondent outlined that they would still think the minimum delivery tonnage requirement of 2,000 tonnes for a 150k-300k tonnage capacity warehouse would be needed, but there was also a desire for a linear step increase to this requirement as the warehouse capacity increases. It was argued that this would have a positive impact on reducing load-out delays.

The LME is greatly appreciative of those respondents that have raised additional matters. The LME acknowledge both the arguments and other suggestions put forward in the responses to question 15. Responses will be considered by the relevant teams internally and communicated to the market in due course. Specifically, the question of simplification is further explored in the Consultation.

4 CONCLUSION

The LME remains very thankful to all its market participants who reviewed and responded to the discussion paper. Further, the Exchange hopes that the above analysis appropriately does justice to the time and effort that respondents have taken in providing the feedback and sharing the benefit of their expertise with the LME. The LME looks forward to engaging further with all its market stakeholders in respect of the Consultation, and will be open to meeting on that topic in due course.